State Sales Taxes and Services

a presentation by

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Introduction

There is no magic formula that will allow governments to painlessly manage the economic downturn. The delivery of state services is dependent on only two factors - the quantity and quality of services demanded by a state's citizenry and that citizenry's ability and willingness to pay for those services. This paper does not address the level of spending that is appropriate. Neither does it address every important issue that is currently part of the public discourse about state and local taxation. It seeks only to summarize some of the ways in which states are raising revenues and suggest meaningful criteria for evaluating tax systems.

Principles of a "Good" Tax System

- Taxes should be adequate to provide an appropriate level of those goods and services best provided by the public sector, such as education, public safety and transportation.

- Taxes should do the least harm to the private economy. Tax bases should be as broad as possible so that tax rates can be as low as possible.

- Taxes should not only be fair and equitable towards individuals and businesses similarly situated, but also they must be perceived as fair by taxpayers. Individuals with the same income level should bear the same or similar tax burden. Businesses engaged in similar commercial activities should be subject to the same level of taxation.

- Taxes should not be costly for government to administer and should be easily understood by taxpayers so as to maximize taxpayer understanding and minimize taxpayer compliance costs.

- Taxes should be evaluated on the basis of the impact of all taxes levied on taxpayers, not just a single tax or tax rate.

- Deviations from sound tax policy in pursuit of economic development, social or other goals should be well-reasoned and implemented only when established tax policies are not significantly undermined and the results of such deviations can subsequently be evaluated.

State Taxes

States and local governments obviously have a need for monies to pay for the services that they provide to the people and institutions of their jurisdiction. The most common broad traditional bases to which tax are imposed are sales, income and property. In addition there are specialty taxes on such items as tobacco, motor fuel, insurance and others. A list of the taxes traditionally collected by the states appears below.

Alcoholic beverages taxes
Amusements taxes
Compensating (Use) taxes
Corporation licenses
Corporation net income taxes
Death and gift taxes
Documentary taxes
Stock Transfer taxes
Gross Receipts taxes
Hunting and fishing licenses
Individual income taxes
Insurance premiums taxes
Motor fuels taxes
Motor vehicle licenses
Motor vehicle operators' licenses
Occupation and business licenses
Pari-mutuels taxes
Property taxes
Public utilities taxes
Public utility franchise
Sales taxes
Severance taxes
Tobacco products taxes

Sales Taxes

Sales taxes began as simple applications of a tax rate to the retail price of sales of tangible personal property. State sales and use taxes initially came into use during the Great Depression. More than half of state sales taxes were enacted during the 1930s.[1] Since the economy was largely one of trade in tangible goods at that time and there was an aversion to imposing tax on personal labor services, most sales taxes were originally applied only to sales of tangible personal property and not to services. Sales taxes are often deemed "fair" taxes in surveys of taxpayers, perhaps because they are thought of as pennies on the dollar.

Forty-five states and the District of Columbia impose a broad-based retail sales and use tax at the state level.[2] Those states not levying the tax include Alaska, Delaware, Montana, New Hampshire, and Oregon.[3]

Local governments in 34 states also impose a sales tax.[4] In all but four states, local taxes are imposed as an add-on to the state tax and are collected and administered by the state tax administration agency.[5] In addition, local tax bases as a general matter conform to the state sales tax base. In some states, the local tax is levied in all jurisdictions of a certain type, but the norm is to allow a "local

[1] A second wave of adoptions occurred after World War II as state governments expanded their activities. There were also several adopted in the 1960s as states expanded their financing of elementary and secondary education.

[2] From this point forward, D.C. is treated as a state since its retail sales tax operates identical to those of the other states.

[3] A number of Alaska local governments are authorized to, and do, impose a sales tax. In addition, Delaware imposes a low-rate gross receipts tax and New Hampshire imposes excise taxes (that operate like sales taxes) on transient lodging, certain restaurant meals and a broad range of communications services.

[4] Those states in which localities do not levy a sales tax include Hawaii, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Jersey, Rhode Island, and West Virginia.

[5] In Alabama, Arizona, Colorado and Louisiana, some local governments are authorized to administer their own sales tax. In these states, there is also somewhat more divergence between the state and local tax base.

option" tax in which a locality (or certain types of localities) can choose whether or not to impose a tax. This results in quite a patchwork of sales tax utilization and sales tax rates. Approximately 7,500 separate local jurisdictions impose a sales tax in the U.S.

For the large part, local sales taxes are levied for general purposes by local governments (cities and counties) as opposed to special purpose districts such as school districts or flood control districts. The use of sales taxes for certain special purposes (*e.g.,* transit) is becoming more common.

Exemptions from the Sales Tax Base. State and local sales taxes have three types of exemptions: (a) Product-based exemptions in which a product or service is exempt regardless of who purchases it or for what purpose;[6] (b) Use-based exemptions in which the exemption is dependent on the use to which it is to be put; (For example, a product purchased to be used in producing a subsequent product to be sold at retail may be exempt, but it would not be if purchased for final consumption.); and (c) Entity-based exemptions in which all or certain purchases by particular types of entities (e.g., schools, charities) are exempt.

States vary widely in their exemption practices, but all of them have a variety of exemptions aimed at eliminating the tax on intermediate or wholesale transactions and imposing the tax only on final consumption, e.g., exemptions of sales for resale, ingredient and component parts and the like. Still, states apply their taxes to a wide range of business inputs and intermediate goods, particularly in the service sector where few services are taxed on final consumption. See discussion below.

The most common product-based exemptions are aimed at excluding the tax on what are considered items of necessity, e.g., food for home consumption and prescription drugs. As shown in Table I, every sales tax state exempts prescription drugs from the tax, and about thirty states exempt (or are phasing in an exemption) food for home consumption from the tax. Several others subject food to a rate that is lower than the general sales tax rate.

"Pyramiding", i.e., the application of tax to prior tax amounts in successive commercial transactions is one problem often cited with the sales tax. Taxing more services can actually exacerbate the problem of pyramiding of the tax. The other issue frequently cited with regard to the sales tax is the inequity created when the sales tax applies "necessities" which account for a greater percentage of income of low-income people. This problem has been reduced in recent years as states have removed the tax from sales of food and other essential items. Economists object to the application of the tax to business inputs, suggesting instead that the sales that should be taxed are those to ultimate consumers.

[6] State and local sales taxes are generally imposed on all sales of tangible personal property unless specifically exempted, but only on specifically enumerated service transactions. Thus, most services would be deemed to be excluded, rather than exempted, from the tax. See further discussion below.

Taxation of Services

Despite the significant change in the U.S. economy and the increasing proportion of economic output that is attributable to services, states have not, to a great degree, extended the reach of the tax to services. Only three states – Hawaii, New Mexico and South Dakota – impose their tax generally on transactions involving services.

Another group of about 10 states impose their tax on a fairly wide range of utility, admissions and amusement and labor repair services (when applied to tangible personal property.) These states, however, tend not to impose the tax on professional services (e.g., lawyers, accountants or medical), and they exhibit a mixed patter in terms of applying the tax to other business and personal services.

States have encountered a variety of political, economic and administrative obstacles when they have attempted to extend the sales tax to services. Massachusetts and Florida undertook such efforts in 1990 and 1987, respectively, and repealed the enactments within six months of the time they were passed. Among the reasons for repeal (that also influenced decisions in other states) were extreme opposition among providers of some services being subjected to tax, concern about the taxation of business inputs, and difficulties in effectively and efficiently sourcing transactions where services are provided or consumed on a multistate basis.

Despite these experiences, the fact is that in recent years the focus of most of the efforts at expansion of the sales tax base has been services as that sector of the economy has grown. In 2008 the Federation of Tax Administrators (FTA) updated its survey of the taxation of services. FTA first conducted a survey of service taxation in 1990. The survey has been updated periodically and the latest survey was published in 2008 and reflects data as of July 2007. The Commission has been furnished a copy of the results of this survey.

FTA sent a list of 168 different services and asked states to list the taxable status of each service. A tax official in the state specified whether the sales tax applied, a special excise or gross receipts tax applied, or whether the service is exempt from taxation. Space was also provided for the official to describe exceptions and include notes to clarify the status. Please note that the list of services in this survey is not a comprehensive list of all services that can or should be taxed. The list was selected to identify different categories in order to provide readers with a picture of how much each state taxes services. FTA received responses from 42 states and the District of Columbia. For states not responding, the 2004 responses were used.

The results of this update illustrate that most states tax services to some degree. Utility services are taxed in most all states and admissions and repair services are taxed in many states. On the other hand, few states tax personal and business services. Professional services, such as doctors and lawyers, are taxed in only a few states.

Only Hawaii and New Mexico have broad-based sales taxes that include most all the services (160 and 158, respectively) tracked by the survey. Delaware and Washington tax a large number of services, mainly through their low-rate business gross receipts taxes. South Dakota and West Virginia are the only other states to tax more than 100 services.

Several other states apply tax to a significant number of selected services. These include Arkansas, Connecticut, District of Columbia, Iowa, Kansas, Mississippi, Nebraska, New Jersey, Texas, and Wisconsin. These states widely tax utilities, admissions/amusements and labor and repair services, but leave professional services largely untaxed. Of these states, Connecticut, District of Columbia and Texas tax more computer service than is the norm for most states. Also, Connecticut taxes more business services while Iowa taxes more personal and business services than others in this group.

When comparing the 2007 results with the 2004 survey, FTA found that very little has changed in the level of state service taxation. The strong economy and good state finances have led policymakers to be reluctant to impose tax increases or new type of taxes. Only New Jersey enacted legislation to expand the taxation of services. Maryland and Michigan also enacted legislation to tax additional services but legislation in these states was repealed before implementation. Facing a budget deficit in 2006 and a need to provide local property tax relief, New Jersey lawmakers enacted a tax package that included an increase in the sales tax rate and broadened the base to include more services. Some of the services included in the tax base include storage, tanning and massage services, limousine services and information services. This raised the number of taxable services in New Jersey from 55 services in 2004 to 74 services in the current survey.

It should be noted that our 2004 survey update describes Nebraska's addition of services to its tax base. Nebraska situation then was somewhat similar to South Carolina's now in that 2002 was the ending of a recession and states needed revenue.

In 2002 Nebraska policymakers enacted legislation eliminating exemptions for certain services that were taxable in neighboring states. The legislation increased the number of services taxed from 49 (as recorded in the 1996 survey) to 76 (by 2004). These increases came in the following areas: Business taxes, added nine services; repair services, adding eight services; and seven other miscellaneous services were also added."

Our 2008 survey shows South Carolina taxing 35 services out of our total of 162 possibilities. Your neighboring states service taxation numbers are:

Alabama-37	**Florida-63**	**Georgia-36**	**Kentucky-28**
North Carolina-30	**Tennessee-67**	**Virginia-18**	**West Virginia-105**

Please note that I am not advocating the taxation of any particular service, only pointing out what is going on in other states.

You have the complete report, including the list of services queried and the responses from the states. It is also available on the Federation of Tax Administrators website, www.taxadmin.org at http://www.taxadmin.org/fta/pub/services/services.html.

I would commend to your reading also a report published in July 2009, by the Center on Budget and Policy Priorities, a Washington-based policy group. I have included a copy of the report to my submission to you. While the report generally advocates the taxation of services based on the organization's policy perspectives, it was written by a thoughtful economist named Michael Mazerov. Michael has an extensive background in taxation and takes a very measured, quite even-handed approach to the issue in the report. It references the FTA survey and creates some use comparative charts with which you can compare South Carolina's approach to that followed by other states. The report analyzes the difference between potentially taxing business inputs and household services. It also points out that there are some business inputs that could, from an economist's point of view, reasonably be taxed. The report breaks down the categories of possible taxation as follows:

- services primarily purchased by businesses, such as payroll processing and television advertising;
- services primarily purchased by households, such as diaper service and cable TV; and
- services frequently purchased by both households and businesses, such as landscaping and pest control.

It goes on to point out that there two countervailing considerations to the argument that no business inputs should be taxable:

- State sales taxes already apply to numerous purchases of goods by businesses. Assuming that the concerns of economists about the distorting effect on resource allocation of taxing business inputs are valid, economic theory implies that the distortion grows as the tax rate increases. If the choice is between increasing the tax rate at which business-to-business sales of goods are taxed and taxing some business-to-business sales of services in order to hold down the tax rate, the latter could actually have a less adverse impact on the efficient allocation of resources.

- In an economy in which a growing number of people run their own businesses, exempting all purchases of goods and services by businesses would open the door to substantial tax evasion. Business owners could claim that purchases of many services — such as telecommunications, hotel rentals, and auto and computer repair — were for business use when they were actually for personal use. Preventing this abuse would require

> that substantial additional resources for tax enforcement be provided to state tax departments. The costs of preventing tax evasion could exceed the economic benefits of exempting business inputs from taxation.[7]

The report includes a table that indicates the revenue yield that South Carolina might experience by taxing what the report calls "feasibly-taxable" services. The amount shown is $955,000,000. Once again, I do not vouch for the accuracy of these numbers, nor am I advocating the taxation of any service. But I do commend the report to you as a useful informational source.

The other big issue in the state sales and use tax area is the policy-litigation-legislation matter of the states' ability to require collection of use taxes by sellers that do not have a physical presence in the taxing jurisdiction. This issue has existed for decades as a result of two opinions of the United States Supreme Court. Essentially the rule is that a taxing jurisdiction may not require a seller of taxable goods or services to collect a sales or use tax unless the seller has a physical presence in the taxing jurisdiction. Unless this ruling is overturned by the Court or changed by Congress enacting a different standard in the exercise of its power to regulate interstate commerce, the states are denied an efficient way of collecting these taxes.

Legislation has been introduced in Congress for many years without any significant progress. The states have taken steps to improve their chances of change through the work of the Streamlined Sales Tax Project that led to the adoption by 22 states of the Streamlined Sales Tax Agreement, essentially an agreement to simplify the administration of sales and use taxes to reduce the burden on interstate commerce. South Carolina is not a participating state in this effort.

Does the present economic crisis mean that South Carolina should reconsider whether or not it wants to participate in the Streamlined Sales Tax Agreement or that the Congress should move ahead with the legislation to give the states the power to require remote sellers to collect? These are ultimately fiscal-political decisions that carry significant consequences for South Carolina and the other states and for the policy makers who make the decisions.

Taxation and Public Trust

In a speech delivered to the 101st Annual Conference on Taxation of the National Tax Association in November 2008, Dr. Tom Wolf, then Secretary of Revenue of the Commonwealth of Pennsylvania, addressed the issue of public goods and taxation. In that speech, he made the following assertion: "There is in fact a connection between taxation and public trust – between tax policy and political legitimacy, and it runs through public goods. The problem is that we do not pay for

[7] "Expanding Sales Taxation of Services: Options and Issues", Center on Budget and Policy Priorities, July, 2009

the public goods we want. For the most part, we balk at paying for them not because we don't want to consume them, but because we believe the system used to raise funds for those public goods – our tax system – is unfair."

He went on to observe that Americans have come to believe two totally contradictory things at the same time – that we can have both low taxes and robust public goods. He further suggested that the economic crisis is an opportunity. It is an opportunity because all of us are now forced to look both at our revenue systems and the cynicism that exists about government in general and taxes in particular. That imperative presents a compelling, politically credible reason to think about comprehensive fundamental tax reform.

Summary

Raising revenue and spending are the two sides of the same coin. Less spending means less tax that must be collected. It is not the purpose of this paper to suggest a level of taxation that is appropriate or even the best methods of raising revenue. One suggestion I would make is that it is always appropriate to do a "reality check" on decisions of policy makers. The decision is ultimately one that is difficulty for policy makers to make, choosing winners and losers from among the constituencies who elect them. Supreme Court Associate Justice Oliver Wendell Holmes said, "Taxes are the price we pay for a civilized society". We should always remember that the greater good is the goal and reason, honesty, selflessness and trust are the paths that must be taken to achieve it.

Helpful Resources

Tax Rates and Tax Burdens in the District of Columbia - A Nationwide Comparison 2008; Issued September, 2009 by the Government of the District of Columbia; http://www.taxadmin.org/fta/rate/DC_Tax_Burden_08.pdf

2007 State Revenues per Capita & Percentage of Personal Income; http://www.taxadmin.org/fta/rate/07taxbur.html

2007 State Revenues by Source (kind of tax); http://www.taxadmin.org/fta/rate/07taxdis.html

2008 State Sales Tax Holidays; http://www.taxadmin.org/fta/rate/sales_holiday.html

State Income, Sales and Excise Tax Rates http://www.taxadmin.org/fta/rate/tax_stru.html

Summary of Key Tax Issues on November 2008 State Ballots http://www.taxadmin.org/fta/rate/b-2708.html

"Expanding Sales Taxation of Services: Options and Issues", Center on Budget and Policy Priorities, July, 2009